CHAPTER 21
SOUTH KOREA

Introduction. The South Korean economy experienced a painful slowdown in 2001.

- After growing at a lively 8.8% in 2000, GDP grew only 2.5% in 2001.
- ROK's trade surplus shrunk—decreasing the net inflow of assets.
- The *won* depreciated 15% from 1100 *won* per dollar in 2000 to 1300 in 2001.

Slowdown

Origins of Slowdown. Troubles surfaced in late 2000 and early 2001.

- The faltering global technology sector weakened the demand for South Korean electronic products.
- The collapsing high tech sector triggered a shocking 12% quarter-on-quarter contraction in GDP in 1Q01.
- In late March 2001, the *won* touched a 30 month low of around 1,365 *won* to the U.S. dollar—dropping about 8% since the start of 2001.

Decline in Manufacturing. The year 2000 saw a steady deceleration of manufacturing. In 3Q01 it saw a 1.6% decline (vs. 3Q00).

- Companies first experienced a marked build up in inventory levels, reflecting the continued weakness of demand in the global technology industry.
- Companies now foresee a recovery in overall industry only when the information technology (IT) industry turns around.

Shrinking Trade Surplus. Korea's shrinking trade surplus is due to a recovery of import demand after the crisis of 1997 and to reduced global IT demand.

- The trade surplus in 2001 was one-fourth of the $39B peak in 1998.
- Imports declined dramatically after the crisis of 1997, but now are recovering—although imports do not exceed exports as was the case before 1997.
- Total exports declined 12% during 2001. By 2Q01, the global downturn in the IT sector had reduced Korea's electronic

Figure 21-A. Selected Historical Data

$ Billions (or %)	**'97**	**'98**	**'99**	**'00**
Gross National Income	485.2	369.9	397.9	457.2
Purchasing Power	618.0	569.5	685.7	823.9
Real Growth (%)	5	-6.7	10.9	8.8
Inflation (%)	4.4	7.5	0.8	2.3
Exports	136.1	132.3	143.7	172.6
To U.S.	23.8	24.8	31.8	40.1
Imports	144.6	93.3	119.8	160.5
From U.S.	25.1	16.5	22.2	27.3
FDI from U.S.	6.5	7.4	8.6	9.4
In U.S.	0.6	1.4	1.9	2.7
Cur Account /GDP %	-1.7	12.6	6.0	2.5
Fiscal Balance /GDP %	-0.9	-3.8	-2.7	2.5
External Debt /GDP %	28.9	44.5	32.3	29.4

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 21-B

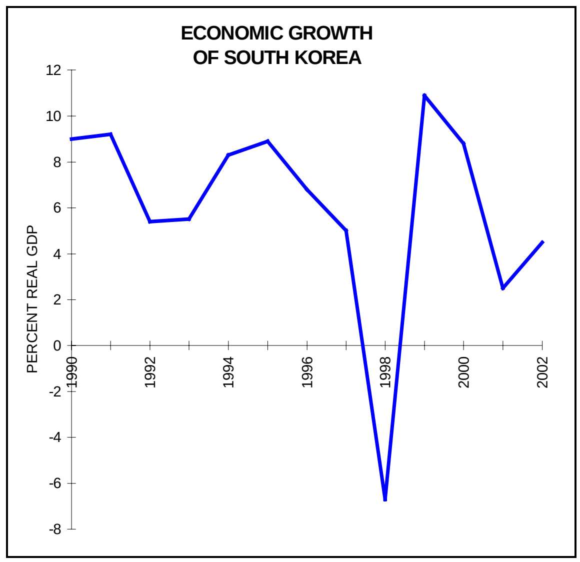


Figure21-C

exports by over one-fourth those of a year earlier. The trend continued through 2001.

- The *won's* depreciation served to reduce imports and help keep a positive surplus.

ROK Vulnerabilities. With nearly half of its GDP accounted for by exports, Korea's economy is vulnerable to the U.S. and global slowdown.

- IT leads the economy.
- Weakness in the important semiconductor industry is partially responsible for the downturn.
- Prices for the standard 64 Megabyte DRAM semiconductor chip have fallen sharply since early 2000.
- To make matters worse, Korean businesses tends to be highly leveraged, and a slowdown in production often leads to a sharp rise in bad debt and tension in the banking system. These tensions, in turn, cause consumers to cut back on spending.

Inflation. In addition, inflation is heating up due to higher energy costs, higher food costs (due to drought in June and rainfall and flooding in July), and a weaker *won*.

- The combination of inflation and economic slowdown has resulted in stagflation.

Divided over Stagflation. The Bank of Korea (BOK) and the Ministry of Finance and Economy (MOFE) are divided over which economic problem to highlight and which policy prescription to follow, e.g., currency policy.

- BOK is concerned that the weak *won* raises import prices and stokes inflationary fires. So in April 2001 BOK announced it was prepared to intervene directly in the currency markets by using foreign exchange reserves to buy *won* and hopefully strengthen it.
- MOFE disagreed and quickly repudiated BOK's intention to strengthen the *won*. MOFE is alarmed over falling South Korean exports (cited earlier). Since many South Korean exports go head to head with Japanese exports, MOFE says it's important for the *won* to remain weak and competitive against a weak yen.

Troubled Recovery and Reforms

A False Dawn? It is now clear that a reversion to strong, pre-crisis growth rates has been something of a false dawn.

- At the turn of the century, the extraordinary surge in information technology spending in the United States pulled Korea—and other struggling Asian countries—out of their economic hole.
- But cyclical downturns in global markets make it all the more essential to get-right the long-term fundamentals of the domestic economy.
- In this regard, domestic demand in ROK would have been stronger if the Korean *chaebol* (conglomerates) had not become complacent and delayed the completion of their promised structural reforms.

Sluggish Corporate Restructuring. Meanwhile, the South Korean financial crisis is really not over.

- The collapse of Daewoo was arguably the worst corporate debt nightmare.
- But most other chaebol still have an alarming financial situation, with about twice the amount of debt to equity ratios.
- Although South Korea prides itself on doing things quickly, corporate restructuring in South Korea is very sluggish.

Credit Squeeze. The sluggish pace of corporate reform is amplified by the sheer size of corporate debt.

- This mountain of corporate debt has triggered a credit squeeze.
- Promising start-up companies—where all the growth has been this year—cannot get credit.
- The immediate fear is that South Korea could face a domestic debt crisis as South Korean corporate liquidity dries up.

Cautious Banks. The main cause of the credit squeeze is bank caution about lending.

- Banks have the liquidity but they refuse to lend to ROK corporations. Why?

- Banks refuse to lend to South Korean companies until they restructure.
- For the recovery to be stronger and more durable, Seoul will have to do more to show investors that it's putting nonviable companies into strenuous debt-restructuring programs. Unfortunately, this is not happening.
- Instead, the government in Seoul is opting for a tactical, stop-gap policy to bail out South Korean corporations.
- Faced with a sharp slowdown in 2001—the government is spending well over $100B to shore up Korea's financial train-wreck.
- Financing is off-budget and is the equivalent of 150% of the ROKG budget or 20-25 % of GDP.

Big Gamble. The government is gambling that future economic growth, huge increases in the value of bank stocks and aggressive selling of the bonds will produce magic.

- This is a gamble that the government will probably lose.
- And if the government loses this gamble, the off-budget headache soon become a fiscal crisis.

Tax Hike Likely. In any case, the government will eventually turn to the taxpayers to bail out these over-borrowed companies.

- That means Korean taxpayers and state assets are likely to be in hock for many years.
- The problem is that the ROK continues to run a centrally planned system.
- The government keeps subsidizing sick and inefficient companies.
- Instead, banks should zero out their bad loans, not just roll them over.

U-Turn on Corporate Reform. For awhile, it seemed that the government was taking a tough line on corporate reform.

- In fact, in 2000, the government was quite willing to let the Daewoo *chaebol* fail rather than to bailout a sick and inefficient *chaebol* with a costly rescue plan.

But recently the gap between the rhetoric of economic reform and the reality has been widening. The slower pace of reform reflects three factors:

- Global economic slowdown,
- "Reform fatigue" among the voters, and
- Kim Dae-Jung's declining popularity.

A Bailout for Hyundai. This shift has been well illustrated in the government's policy U-turn towards one of the largest *chaebol*, Hyundai. The government's determination to keep Hyundai afloat became clear in early 2001 when it brokered a bailout plan for this financially embattled *chaebol*.

- The state-owned Korea Development Bank agreed to buy 4.2 trillion *won* of the maturing bonds issued by Hyundai Engineering and Construction and Hyundai Electronics.
- The government's attitude to Hyundai was in direct contrast to its willingness to let Daewoo fail in 2000.
- The bailout undermines the credibility of the *chaebol* reform program—one of the main platforms of the government's wider reforms.
- The government had previously argued that it was important for sick and inefficient companies to be allowed to fail (i.e., creative destruction).
- The bailout increases the systemic risk in the banking system, retarding the return of the still ailing domestic banks to financial health.

Government Capital Reforms

Wasting Capital. The government's failure to move faster on corporate reform ranks as one of the biggest impediments to growth.

- Capital is still being wastefully allocated across too many failing industries.

Capital Shortfall. New business formation in Korea has been encouragingly robust, running at a rate 50% higher than pre-crisis levels.

- But these new companies are suffering from a dearth of capital—especially following the slide in the Kosdaq stock market index.

Will Cure Kill the Patient? At this point in the economic cycle there is a danger that the cure could be worse than the disease.

- Widespread corporate restructuring may result in big job losses, further hitting domestic demand just as the economy is decelerating.

Needed: Creative Destruction**.** But taking excess capacity out of some markets—such as semiconductors, for example—would increase the profitability of the remaining players and improve investor confidence abroad.

- The government has enough fiscal leeway to bolster welfare support and to stimulate demand by investing in better public transport and improving the infrastructure.

Wanted: A Coherent Economic Strategy. The government's challenge is to provide clarity and purpose.

- It should draw up a clear plan, setting out how and when it will start reducing corporate subsidies—and then stick to it.
- The tragedy for Korea is that the likelihood of this happening before the next presidential elections in December 2002 is now negligible.

A Better Way**.** Instead of using public resources to prop up bankrupt *chaebol* such as Hyundai, the government should shift resources to bolstering education and training for the unemployed.

- Korea's bloated *chaebol* should finally be exposed to the full blast of market disciplines.

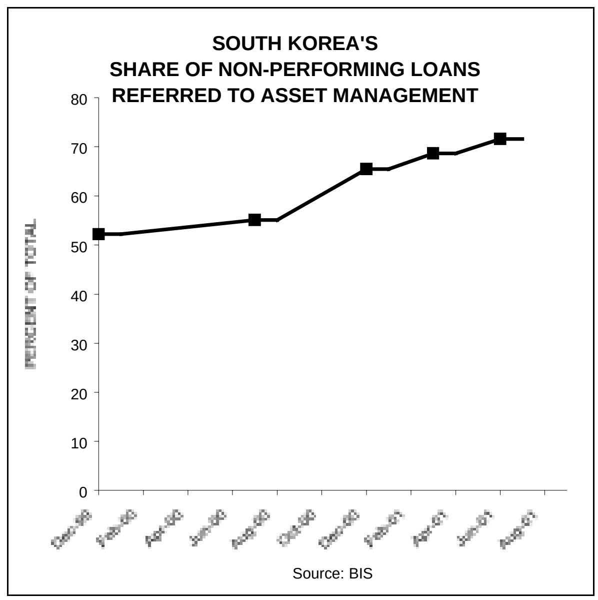
Danger of Delaying Reform. Is there an optimum time to reform? Implementing reforms can be paradoxical. When times are good, no one sees the need. When times are bad, it hurts too much.

- But delaying reform indefinitely risks triggering a crisis and magnifying the eventual pain.
- Such is the dilemma now confronting South Korea.

ROK Strengths. The good news is that the South Korean economy has important strengths that give it a fighting chance to implement the economic reforms, notwithstanding the economic slowdown.

- Record foreign exchange reserves give the Bank of Korea room to cut interest rates with less worry about an outflow of capital than it did during the 1997 debacle.
- The Bank of Korea's lower interest rates have softened the blow from weaker global demand for ROK exports.
- In contrast, in the 1997 crisis the won was linked to a rising U.S. dollar and the Federal Reserve had been raising interest rates.

Figure 21-D



Progress on Bank Reforms. In addition, Korea has at least made some progress on bank reforms after the 1997-98 financial crisis. In a number of ways, the banks are starting to clean up their act.

- The government has spent more than $100B cleaning up the financial sector since the start of the financial crisis in Asia four years ago.
- As a result, the ROK Financial Supervisory Service (or financial watchdog) reports that the costly reform of the country's financial sector is finally bearing fruit.

- South Korea's commercial banks have managed to more than halve their bad loans during the past one-and-a-half years.
- There are now just 5.6% of loans without much of a chance of being repaid, down from 13.6% at the end of 1999.
- There is gradual progress in the share of non-performing loans being resolved by an asset management organization.
- South Korea, therefore, has made impressive progress since its financial crash in 1997-98. However, it still has a long way to go to create a sound and internationally competitive economy.

Conclusion

As with many Asian countries, South Korea's economic growth has been vulnerable to recent changes in the IT market. The key to long-term growth, however, is the ongoing improvement of the fundamentals of the domestic economy. As such, South Korea's economic reforms are a mixed bag.

- There is evidence of some progress on bank reforms.
- Initially, ROK made some progress on corporate reforms. For instance, the government let Daewoo fail. But recently, the government has done kind of a U-turn on corporate reform. In fact, the government's bailout of Hyundai is in direct contrast to how the government handled Daewoo.

If South Korea ever expects to enjoy long-term economic growth, the government should allow South Korean corporations to face the discipline of the free market.